IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

TAX APPEAL No 107 of 2002
WITH
CIVIL APPLICATION No.11 of 2004

For Approval and Signature:

HON'BLE MR.JUSTICE M.S.SHAH Sd/-
and
HON'BLE MR.JUSTICE D.A.MEHTA Sd/-

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1. Whether Reporters of Local Papers may be allowed to see the judgements?

2. To be referred to the Reporter or not? : YES

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the concerned Magistrate/Magistrates,Judge/Judges,Tribunal/Tribunals? : NO

KWALITY STEEL SUPPLIERS

Versus

C.I.T.

Appearance:

1. TAX APPEAL No. 107 of 2002
MR SN SOPARKAR WITH MR TUSHAR P HEMANI for Appellant.
MR BB NAIK for Respondent No. 1

CORAM : HON'BLE MR.JUSTICE M.S.SHAH
and
HON'BLE MR.JUSTICE D.A.MEHTA

Date of decision: 06/08/2004

ORAL JUDGEMENT

(Per : HON'BLE MR.JUSTICE D.A.MEHTA)

1 In this appeal the following two substantial questions of law arising from the order of the Income Tax Appellate Tribunal (the Tribunal) have been framed at the time of admission of the appeal :

"1. Whether, in the facts and circumstances of the case, the ITAT was right in law, in holding that the C.I.T. has validly exercised revisional jurisdiction under Section 263 of the Income-Tax Act,1961?

2. Whether, in the facts and circumstances of the case, the ITAT was right in law, in holding that closing stock was to be valued at market price on the ratio of the decision of the Supreme Court in ALA Firm vs. C.I.T. reported in 189 ITR 285 though the business was continued after the dissolution of the firm ?"

2. The appellant filed return of income on 30/10/1993 showing total income at Rs.16,41,760/- for assessment year 1993-94. The relevant previous year is financial year 1992-93. The assessment was finalized on a total income of Rs.20,52,210/- on 24/2/1995 under Section 143(3) of the Income Tax Act, 1961 (hereinafter referred to as 'the Act').

3. On 27/2/1997 the respondent issued notice under Section 263 of the Act, as according to him the assessing officer had erred while passing assessment order for assessment year 1993-94. According to the respondent during the accounting year, the firm was dissolved and therefore, the closing stock should have been valued at market rate in view of the decision of the Hon'ble Supreme Court in the case of A.L.A.Firm Vs.Commissioner of Income-Tax (1991) 189 ITR 285.Applying the gross profit rate at around 15% on closing stock of Rs.12 crores approximate an addition of Rs.1.82 crores for undervaluation of closing stock was proposed. The appellant submitted its written reply but the respondent passed an order under Section 263 of the Act on 20/3/1997 setting aside the assessment order with a direction that fresh order be made in accordance with the direction given in his order after giving assessee an opportunity of being heard.

4. The appellant challenged the aforesaid order of the respondent dated 20/3/1997 before the Income Tax Appellate Tribunal by preferring an appeal, being ITA 1568/Ahmedabad/1997. The said appeal came to be heard by the Rajkot Bench of the Tribunal and was disposed of on 28/4/2000, wherein the appeal came to be dismissed upholding the order of the respondent under Section 263 of the Act. Being aggrieved by the aforesaid order dated 28/4/2000 the appellant has challenged the same and the aforesaid two substantial questions of law have been framed by this Court while admitting appeal on 26/2/2002.

5. Mr.S.N.Soparkar, learned Senior Advocate appearing with Mr.Tushar P.Hemani submitted that the Tribunal had erred in confirming the order of the respondent under Section 263 of the Act, because firstly, the respondent had wrongly assumed revisional jurisdiction under Section 263 of the Act, and secondly, the business had been continued after dissolution of the firm and therefore the ratio of decision of Supreme Court in A.L.A.Firm (supra) was applicable in favour of the appellant and not in favour of the revenue. It was submitted that , once the factum of same business having continued on death of one of the partners was accepted, closing stock had to be valued at cost and not at market price. That the erstwhile partnership firm consisted of two partners i.e. the mother and son; the mother expired and the son continued the same business as a proprietor.

5.1. Mr.Soparkar referred to and relied upon the additional affidavit dated 16/2/2004 filed by the appellant and referred to the Deed of Partnership to contend that vide clause 17 it was provided that the partnership business shall be continued by the other partner in case of sad demise or retirement of any one of the partners. Attention was invited to the accounts made up as on 11.2.1993 when one of the partners expired, and accounts for the period from 12/2/1993 to31/3/1993 to show that the same figure of closing stock had been shown to be the opening stock of the proprietary business to emphasis that the same business had continued. Similarly the assessment order in case of Proprietor was also referred to show that the same business of shipbreaking was carried on by the proprietor in light of the fact that all the assets and liabilities were willed away by the deceased partner to the surviving partner.

5.2 In support of the proposition that the respondent could not have exercised jurisdiction under Section 263 of the Act reliance was placed on the decision of the Apex Court in case of Malabar Industrial Co.Ltd. Vs. Commissioner of Income-Tax (2000) 243 ITR 83, and it was contended that where two views were possible and the assessing officer had taken one view with which the Commissioner did not agree, the assessment order could not be treated as an order erroneous and prejudicial to the interests of the revenue.

5.3 In relation to the second question as to whether the closing stock had to be valued at cost or market price, reliance was placed on the Apex Court decision in the case of Sakthi Trading Co. Vs. Commissioner of Income-Tax, (2001) 250 ITR 871 to submit that the earlier decision in the case of A.L.A.Firm had been referred to and in the subsequent decision the Apex Court had categorically held that for the purpose of valuing the closing stock at market value in a case of dissolution of a firm discontinuance of the business was a necessary concomitant. The decisions of the Madras High Court in the case of Commissioner of Income-Tax Vs.Standard Printing Machinery (2003) 260 ITR 268 and Karnataka High Court in case of Commissioner of Income-Tax Vs. Mangalore Ganesh Beedi Works (2004) 265 ITR 658 were also relied upon in support of the proposition that both the High Courts had read the decision in case of A.L.A.Firm to mean that when there was no cessation of business the closing stock ought to be valued at the cost or market price, whichever is lower.

6. Mr.B.B.Nayak, learned Standing Counsel appearing on behalf of the respondent submitted that the facts of the present case were similar to the facts in case of 'Ramchari (G.R.) and Co. Vs. Commissioner of Income-Tax (1961) 41 ITR 142 (Mad.)' and the said decision had been held to be laying down the correct law by the Apex Court in case of A.L.A.Firm (supra). It was contended that the business was not continued by the partnership firm but was continued by the surviving partner. That the firm was constituted by two partners and on death of one of them dissolution took place by operation of law and therefore, the business continued by the surviving partner could not be termed to be the business of the partnership firm. It was further submitted that the valuation of the closing stock was only for the purpose of assessment of the erstwhile firm and the revenue was not concerned with whether, the surviving partner continued the business or not, and whether the surviving

partner adopted the same figure i.e. figure of closing stock as opening stock of the proprietary business. Mr.Nayak read extensively from page 147 of 41 ITR 142, the decision of Madras High Court in case of 'Ramchari (G.R.) and Company', to emphasise that whether the surviving partner took over the entire stock and continued to run the business on his own or not was not relevant at all.

7. In case of Malabar Industrial Co.Ltd. (supra) the Apex Court has enunciated the law in relation to Section 263 of the Act thus :

"A bare reading of this provision makes it clear that the prerequisite to the exercise of jurisdiction by the Commissioner suo motu under it, is that the order of the Income-tax Officer is erroneous in so far as it is prejudicial to the interests of the Revenue. The Commissioner has to be satisfied of twin conditions, namely, (i) the order of the Assessing Officer sought to be revised is erroneous; and (ii) it is prejudicial to the interests of the Revenue. If one of them is absent- if the order of the Income-tax Officer is erroneous but is not prejudicial to the Revenue or if it is not erroneous but is prejudicial to the Revenue-recourse cannot be had to section 263(1) of the Act.

There can be no doubt that the provision cannot be invoked to correct each and every type of mistake or error committed by the Assessing Officer, it is only when an order is erroneous that the section will be attracted. An incorrect assumption of facts or an incorrect application of law will satisfy the requirement of the order being erroneous. In the same category fall orders passed without applying the principles of natural justice or without application of mind.

The phrase 'prejudicial to the interests of the Revenue' is not an expression of art and is not defined in the Act. Understood in its ordinary meaning it is of wide import and is not confined to loss of tax."

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"The scheme of the Act is to levy and collect tax in accordance with the provisions of the Act and

this task is entrusted to the Revenue. If due to an erroneous order of the Income-tax Officer, the Revenue is losing tax lawfully payable by a person, it will certainly be prejudicial to the interests of the Revenue.

The phrase 'prejudicial to the interests of the Revenue' has to be read in conjunction with an erroneous order passed by the Assessing Officer. Every loss of revenue as a consequence of an order of the Assessing Officer cannot be treated as prejudicial to the interests of the Revenue. For example, when an Income-tax Officer adopted one of the courses permissible in law and it has resulted in loss of Revenue; or where two views are possible and the Income-tax Officer has taken one view with which the Commissioner does not agree, it cannot be treated as an erroneous order prejudicial to the interests of the Revenue, unless the view taken by the Income-tax Officer is unsustainable in law."

8. In the case of A.L.A.Firm (supra), the Apex Court has reproduced two considerations which prevailed with Madras High Court while deciding the case of 'Ramchari (G.R.) and Co.' (supra). The first consideration is that the privilege of valuing the opening and closing stocks in a consistent manner is available only to continuing business and that it cannot be adopted where the business comes to an end and the stock-in-trade has to be disposed of in order to determine the exact position of the business on the date of closure. The second consideration is that the case of a partnership concern which dissolves its business in the course of the accounting year forms a close parallel to the case of a firm which goes into liquidation. That in both the cases all the assets and the stock-in-trade of the business will have to be sold and their value realised for the purpose of ascertaining true state of the profits or losses of the business. The Apex Court thereafter observed that :

"Even in a continuing business, the valuation at market value is permissible only when it is less than cost; it is not quite certain whether the rules permit an assessee if he so desires to value closing stock at market value where it is higher than cost. But, in either event, it is allowed to be done because its effect can be offset over a period of time. But here, where

the business comes to a close, no future adjustment of an over or undervaluation is possible".

It was further observed that :

"We, however, find substance in the second consideration that prevailed with the High Court. The decision in Muhammad Ussain Sahib v.S.N.Abdul Gaffoor Sahib, AIR 1950 Mad 758; [1950] 1 MLJ 81 correctly sets out the mode of taking accounts regarding the assets of a firm. While the valuation of assets during the subsistence of the partnership would be immaterial and could even be notional, the position at the point of dissolution is totally different (at p.759) :

"But the situation is totally different when the firm is dissolved or when a partner retires. The settlement of his account must be not on a notional basis but on a real basis, that is every asset of the partnership should be converted into money and the account of each partner settled on that basis ..... The assets have to be valued of course, on the basis of the market value on the date of the dissolution....."

This applies equally well to assets which constitute stock-in-trade. There can be no manner of doubt that, in taking accounts for purposes of dissolution, the firm and the partners, being commercial men, would value the assets only on a real basis and not at cost or at their other value appearing in the books."

9. Thus, the position that emerges is that valuation of all the assets including stock-in-trade of a firm is to be based on the market value on the date of dissolution for the purpose of settlement of accounts between the partners. The settlement of accounts has to be on a real basis and not on a notional basis. Hence the requirement: to apply the market value while valuing the closing stock in case of dissolution of a firm when there is cessation of business. It must not be lost sight of that while deciding the case of A.L.A.Firm (supra) the factual matrix, in which the Court was called upon to decide the controversy, was that the partners in

that case had revalued the assets at the time of dissolution of the firm, distributed the same amongst two groups of partners and upon such distribution credited surplus on revaluation to the partners' accounts which were duly reflected in the balance sheet, profit and loss account and the profit and loss adjustment account. The said valuation was also reflected in the statement filed along with return of income. However, while computing the taxable income difference on revaluation of the stock-in-trade was deducted on the ground that it was not assessable either as revenue or capital receipt. It is in the aforesaid backdrop of facts that the ratio of the decision in case of A.L.A.Firm (supra) requires to be understood and applied.

10. The respondent revenue seems to have lost sight of the purpose for which valuation of the closing stock is undertaken. The true purpose has been explained succinctly by the Supreme Court in the case of Chainrup Sampatram Vs. Commissioner of Income-Tax, West Bengal (1953) 24 ITR 481 in the following words :

> "It is wrong to assume that the valuation of the closing stock at market rate has, for its object, the bringing into charge any appreciation in the value of such stock. The true purpose of crediting the value of unsold stock is to balance the cost of those goods entered on the other side of the account at the time of their purchase, so that the cancelling out of the entries relating to the same stock from both sides of the account would leave only the transactions on which there have been actual sales in the course of the year showing the profit or loss actually realised on the year's trading. As pointed out in paragraph 8 of the Report of the Committee on Financial Risks attaching to the holding of Trading Stocks, I9I9, 'As the entry for stock which appears in a trading account is merely intended to cancel the charge for the goods purchased which have not been sold, it should necessarily represent the cost of the goods. If it is more or less than the cost, then the effect is to state the profit on the goods which actually have been sold at the incorrect figure ..... From this rigid doctrine one exception is very generally recognised on prudential grounds and is now fully sanctioned by custom, viz., the adoption of market value at the date of making up accounts, if that value is less than cost. It is of course an anticipation of the loss that may be made on those goods in the

following year, and may even have the effect, if prices rise again, of attributing to the following year's results a greater amount of profit than the difference between the actual sale price and the actual cost price of the goods in question' (extracted in paragraph 281 of the Report of the Committee on the Taxation of Trading Profits presented to British Parliament in April I95I). While anticipated loss is thus taken into account, anticipated profit in the shape of appreciated value of the closing stock is not brought into the account, as no prudent trader would care to show increased profit before its actual realisation. This is the theory underlying the rule that the closing stock is to be valued at cost or market price whichever is the lower, and it is now generally accepted as an established rule of commercial practice and accountancy. As profits for income-tax purposes are to be computed in conformity with the ordinary principles of commercial accounting, unless of course, such principles have been superseded or modified by legislative enactments, unrealised profits in the shape of appreciated value of goods remaining unsold at the end of an accounting year and carried over to the followiong year's account in a business that is continuing are not brought into the charge as a matter of practice, though, as already stated, loss due to a fall in price below cost is allowed even if such loss has not been actually realised".

11. These principles have been reiterated in the subsequent decision in case of Sakthi Trading Co.(supra), and the Supreme Court itself has read and applied A.L.A.Firm's case (supra) in the following words :

"From the above, it is evident that in A.L.A.Firm's case [1991] 189 ITR 285, this court was considering the question of valuation of closing stock at market value in a case where there was dissolution and also discontinuance of the business of the firm. In that case after dissolution, two groups were carrying on separate businesses with the assets and liabilities which fell to their shares from the dissolution of the firm. In the present case, however, though there was dissolution on account of the death of one of the partners, there was no discontinuance of the

> business. The unchallenged finding recorded by the Tribunal is that there was no discontinuance of business. Even as per principles laid down in A.L.A.Firm's case [1991] 189 ITR 285 (SC) in such a case the closing stock is to be valued at the cost or market price, whichever is lower. That is an established rule of commercial practice and accountancy. The High Court was clearly in error in relying upon the decisions of the Madras High Court in the cases of G.R.Ramchandri and Co.'s case [1961] 41 ITR 142 and A.L.A.Firm's case [1976] 102 ITR 622 for coming to the conclusion that assets had to be valued at market value. As already noticed, in the present case, there was no cessation of business and, therefore, the closing stock could not be directed to be valued at the market rate".

12 Therefore, it is evident that for the purpose of valuation of closing stock in a case where there is a dissolution, market value has to be adopted where the dissolution is accompanied by discontinuance of the business and not otherwise. The established rule of commercial practice and accountancy that closing stock has to be valued at cost or market price, whichever is lower, is accepted and approved both in the case of A.L.A.Firm (supra) and Sakthi Trading Co. (supra), when the business is continuing.

13. The facts of the present case show that the erstwhile partnership firm was constituted of two partners : mother and son. The mother expired on 11/2/1993 leaving behind her share of assets and liabilities of the partnership firm by will to her son who incidentally happened to be the other partner. The result was that the entire business viz. all assets and liabilities came to be held by the surviving partner. It is well settled in law that on death the will of the testator takes effect and there is no hiatus between the point of death and vesting of properties in the legatee. That the surviving partner has continued the same business is not in dispute.

14. In the present case the Tribunal accepts the fact that the business has been continued but misdirects itself in law by harping upon automatic dissolution of the firm and goes on to hold that: "mere fact that the business has been continued cannot lead to the inference that there has been only change in the constitution".

Therefore, the Tribunal fell into error while applying the ratio of the case of A.L.A.Firm (supra), and thus upholding the action of the respondent under Section 263 of the Act. Once the position is accepted that the business continued the ratio enunciated by A.L.A.Firm (supra) and reiterated by Sakthi Trading Co. (supra) would apply with full force and the closing stock has to be valued at the cost or market price, whichever is lower, on the basis of established principles of commerce and accountancy.

15. In these circumstances, it is not possible to state that the order of the assessing officer was in any manner prejudicial to the interests of revenue, there being no error in the assessment order. In other words it is not possible to state that the view taken by the assessing officer is unsustainable in law. Even if the stand of Revenue, that the decision in case of A.L.A.Firm (supra) represents the view of Revenue is considered, there's another view as canvassed by the appellant assessee on the basis of the decision in case of Sakthi Trading Co. (supra). If that be so the respondent could not have exercised revisional jurisdiction under section 263 of the Act.

16. The Tribunal was not right in law in upholding the exercise of revisional jurisdiction under Section 263 of the Act. The Tribunal was also not right in law in holding that the closing stock had to be valued at market price on the basis of ratio of decision of the Supreme Court in A.L.A.Firm (supra) though the business was continued after the dissolution of the firm.

17. In the result, both the questions referred to the Court are answered in the Negative i.e. in favour of the appellant and against the revenue. The appeal is accordingly allowed with no order as to costs.

CIVIL APPLICATION No. 11 OF 2004.

As the main appeal has been disposed of this Civil Application does not survive and is disposed of accordingly.

Sd/-
(M.S.Shah, J)
Sd/-
(D.A.Mehta, J)

m.m.bhatt